National Insurance: A Plan to Blunt the Pain

By Robert Colvile & Tom Clougherty

- UK households are already suffering from horrendous cost of living increases, driven by surging energy prices.

- The Government is about to make the pain even worse by introducing a 1.25% National Insurance increase for both employees and employers, which together with other tax changes will raise an extra £12bn a year.

- If the Treasury will not abandon the NI rises, it should at least compensate for their impact by increasing the threshold for paying employee NI – a tax cut originally proposed by the Centre for Policy Studies and adopted by the Conservatives in their 2019 manifesto.

- Raising the threshold to £11,284, instead of the planned £9,880, would completely protect low and median earners (those on £27,500 and below), limiting the impact of the tax to the most affluent deciles. The cost would be roughly £4.7bn of the planned £12bn.

- This is not a perfect solution – businesses and high earners would still pay more, damaging growth, and separate measures would be needed to address the impact of higher energy bills on the most vulnerable. But at least it prevents the Government adding insult to injury.

Introduction

With every week that goes by, the depth of the cost of living crisis becomes clearer. The one-two punch of the pandemic and the Ukraine crisis saw gas prices increase tenfold over the past year, although they have since subsided slightly.[1] Other prices have also been rising, including clothing and foodstuffs. The energy price cap, having doubled in April, is set to rise again in October. The Institute for Fiscal Studies (IFS) estimates that the median earner (on £27,500) will be £800 worse off next year as a result of the inflationary surge.[2]

This is, therefore, the worst possible time for the Government to be raising taxes on every worker in the country. But in just two weeks' time, a package of tax rises is set to come in – to employer's National Insurance, employee's National Insurance and dividend tax – that raise an extra £12bn, by

[1] Trading Economics, *UK National Gas*. Link
[2] IFS, *Heightened uncertainty and the spectre of inflation hang over the Spring Statement*. Link

increasing rates by 1.25p in the £1.[3] The money will be used to provide extra funding to address Covid-related backlogs in the NHS, before becoming from next year a separate Health and Social Care Levy which will (theoretically) move over from the NHS to plug funding holes in the care system.

The Centre for Policy Studies, among many others, has called for these tax rises to be postponed or cancelled outright. The Treasury, however, is holding firm. It argues that it is irresponsible to leave a £12bn funding gap in the NHS budget, and points out that the progressive structure of the National Insurance rise means that 50% of the total will fall on the richest 15% of earners. Cancelling the increase would, ministers say, advantage the well-off the most while doing little to protect those who are most vulnerable to cost of living pressures. They are also concerned about the inflationary impact of fiscal loosening – before the Ukraine crisis, the International Monetary Fund had suggested that the Government should raise taxes more swiftly in order to cool the economy.[4]

However, there is a way for the Treasury to blunt the impact of its tax increases – indeed, for it to actually cut taxes for those on low incomes. And it is sitting right under the Chancellor's nose.

Raising the National Insurance threshold

In 2018, the Centre for Policy Studies published 'Make Work Pay', a landmark paper arguing for a more worker-friendly tax system.[5] Its proposal to focus tax cuts on the working poor, by lowering the taper rate for Universal Credit, was taken up by Rishi Sunak in his October Budget.[6] But another core proposal was to increase the point on the salary scale at which people start to pay National Insurance.

We pointed out that the increase of the personal income tax allowance – another idea proposed by the Centre for Policy Studies, and adopted by David Cameron and George Osborne[7] – had taken millions of people out of tax. But NI thresholds had lagged behind.

Raising the NI threshold to match income tax would, we pointed out, help the 2.4 million people paying NI but not income tax. It would also enable the Government to create what we called the 'universal working income', guaranteeing that the first £1,000 anyone earned every month would be completely free of tax. Polling for the paper showed that it would be enormously popular – far more so than a universal basic income.

[3] HM Revenue and Customs, *Health and Social Care Levy*. Link
[4] Chris Giles, *UK should bring forward tax rises to fight inflation, IMF says*. Link
[5] Tom Clougherty, *Make Work Pay*. Link
[6] Centre for Policy Studies, CPS welcomes taper rate cut but warns on spending and growth. Link
[7] Lord Saatchi and Peter Warburton, *Poor People! Stop Paying Tax!* Link

Like its predecessor, this policy was adopted by the Conservative Party, with the 2019 manifesto setting out an aspiration to increase the threshold to £12,500 over the course of this Parliament.[8] But then Covid struck – and the commitment was quietly dropped. Indeed, the Conservatives found themselves raising National Insurance rather than cutting it.

Increasing the threshold to £12,500 is probably still unaffordable, given the impact of Covid on the public finances (we estimate it would cost £9.1bn of the £12bn being raised by the NI hikes, if done alongside). But raising the threshold still provides an extremely effective mechanism to cushion the impact of the scheduled NI rises, especially if your goal – as it should be – is to help those on low and average incomes, as they experience an unprecedented cost of living shock.

How would it work?

There are all kinds of options for raising the thresholds. But let us say that our primary aim is to ensure that no one on or below the average income would pay more in employee's NI next year than they do at present: in other words, to shield them from the impact of the tax rise.

There are various complexities and exemptions within the National Insurance system. For the purposes of this exercise, however, we will use the rates and thresholds that apply to the overwhelming majority of workers.

At present, an employee pays NI at a rate of 12% of their salary over an earnings threshold of £184/wk (£9,568/yr). According to the IFS, the median UK earner is on approximately £27,500. (ONS data for employee earnings gives a figure of £26,208, but this does not take the self-employed into account.) They would therefore pay (£27,500 - £9,568) x 0.12 = £2,151.84.

In the new tax year, an employee will pay NI at 13.25% over a threshold of £190/wk (£9,880/yr). That gives a total of £2,334.65. That means the median worker will be £182.81 worse off next year in cash terms.

To offset that increase with a higher threshold, you would need the primary threshold to rise to £11,260, ie by £1,380.27. However, because National Insurance is still calculated on a weekly basis, you would in fact need to increase the threshold to £11,284 (the equivalent of £217/week).

According to HMRC's ready reckoner, doing this for employees would cost £4.455bn in 2022-23. Including the self-employed would cost a further £270m, for a total of £4.725bn.[9]

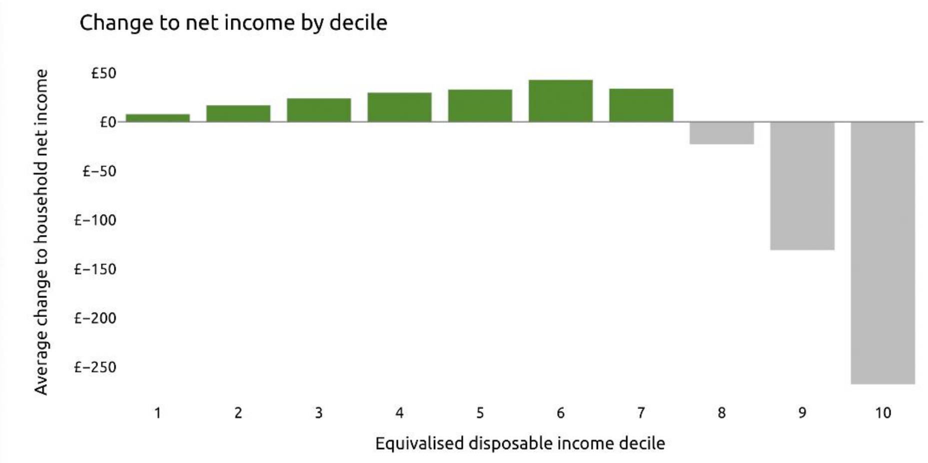
[8] The Conservative and Unionist Party, *Manifesto 2019*. Link

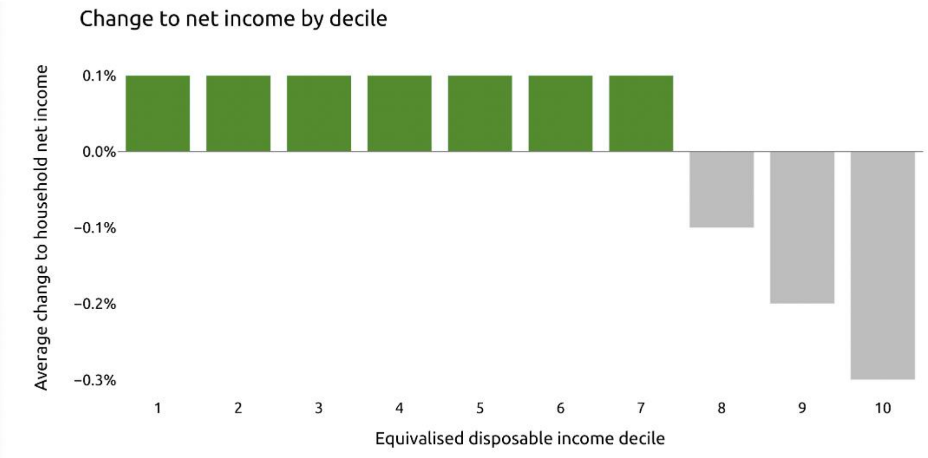
[9] Each £2/week increase for employees costs £330m. Each £104/yr increase for self-employed costs £20m.

The case for raising the threshold

This measure would not be a panacea. Raising the threshold to the point we suggest would cost more than a third of the amount of tax being raised by the new levy, meaning the Treasury would have to make cuts elsewhere, or increase borrowing. The Government would still be harming the economy, and the recovery, by increasing the amount businesses pay via the employer's portion of NI – quite literally, a tax on work. And it would still leave those on above average incomes paying significantly more in tax.

But because every worker in the country would benefit by the same amount – getting back that £182.81 that would have gone to the taxman – this measure is far more progressive than the Government's original plans. In fact, it turns a tax on every worker into a tax purely on businesses and the rich. As this distributional analysis via PolicyEngine.org shows, this plan protects all those up to the top three income deciles.





This plan also protects households from one of the more sinister consequences of inflation: the fact that those on lower incomes tend to get dragged into paying higher rates of tax. In a world of high inflation, the real value of existing tax thresholds will fall correspondingly: with inflation at 8%, the £9,880 threshold today is the equivalent of £10,670 next year. This will reduce the real cost to the Treasury of making these measures – indeed, in a just world they would apply a similar inflationary uplift to income tax thresholds, too.

It is important to stress here that this should not be the limit of the Government's actions. The bulk of cost pressures on families are coming from energy bills, and while there is a limit to how much people can and should be protected from the reality of the market price, there is clearly a case for action to soften the pain. We have suggested transferring the £153 'policy levy' on energy bills to general taxation, cancelling the estimated £70 uplift to household bills to compensate for the cost of the firms that collapsed last year, bringing forward the uprating of Universal Credit to match inflationary pressures (with a correspondingly smaller uplift next year) as well as other smaller measures.

But the core argument of this briefing note is that at a time of grievous pressure on family finances, and real misery for millions of people, the Government should at the very least not be acting to make those pressures worse. This paper sets out a plan to protect those on low and average earnings from a cost of living double whammy. We urge the Chancellor to act accordingly.